

SPECIAL REPORT

From Inflation To Deflation ... And Back!

I have been laying out the groundwork for the next phase of this cycle, which is good news for Main Street even if not that great for Wall Street or my long-held belief in the longevity of this secular disinflationary cycle ... which I think is now in its mature stage.

I think the people that write off the prospect of cost-push inflation are taking on a very myopic view. Inflation is a process, and it takes a long while to build. There is evidence that the consumer deleveraging cycle is largely over. Subprime auto credit is up 30% from a year ago. We are up to a 20% share of mortgages being originated with downpayments of less than 10%. CLO (collateralized loan obligation) issuance is back to 2007 levels. In the corporate space, fully one-third of high-yield debt issues this year have been centred in firms with the weakest balance sheets. At some point, money velocity and the money multiplier will stop falling. No doubt fiscal drag will take a chunk out of GDP growth in the near-term, but this too shall pass and the reality is that the aggregate supply curve (and this is true globally) has become increasingly inelastic. The pool of available skilled labour is shrinking rapidly and after five years of the weakest growth in the private sector capital stock, we are starting to see the lagged ill-effects on productivity growth. Potential non-inflationary growth had already been pared, in my estimates, to 1.7%. And the only way we could have experienced a drop in the unemployment rate in the past year from 8.2% to 7.4% in the face of sub-2% economic growth strongly suggests that we are now on our way to a potential non-inflationary speed limit of just 1%. Very European indeed.

I am not very bullish on the outlook for aggregate demand growth. But the shape of the aggregate supply curve is now so inelastic that it doesn't take much in the way of growth in spending to generate higher inflation over time. I realize that is not evident just yet to the naked eye and this is a process that will be akin to watching grass grow. That is always the case. This is the big risk — margin compression affects the 'E', while inflation, insofar as the tight historical relationship with final prices holds, even if to a smaller degree this time around, affects the P/E. Once again, this becomes a strategy of adding some inflation hedges to the S.I.R.P. portfolio — exposure to tangibles or hard assets, and in some cases like resources and TIPS/RRBS (real return bonds), they have cheapened up very nicely of late. Within the equity universe, dividend coverage/payouts are augmented by screening of sectors and companies that have high-fixed costs and low variable costs, that have high capital/labour ratios and also high demand inelasticities (a.k.a.

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SUMMARY

- Inflation is a process, and it takes a long while to build. There is evidence that the consumer deleveraging cycle is largely over
- The shape of the aggregate supply curve is now so inelastic that it doesn't take much in the way of growth in spending to generate higher inflation over time
- The prospect that we are sitting at over 3% on the 10-year T-note yield a year from now and north of 4% by 2017 is hardly trivial
- If you are an investor, don't spend too long debating whether you should be starting to hedge your portfolio against the prospect of a rising long-term interest rate environment

‘pricing power’). Stay tuned as this theme becomes more fully fleshed out in the near future. Better to be prepared for shifts in the landscape than to be surprised.

I keep emphasizing that it took Paul Volcker a good three years to kill inflation for good and it is taking longer for Bernanke to dispel deflation concerns even if the U.S. economy in terms of consumer prices has never deflated once in the past six decades, but he will ultimately be successful and my call for higher long-term rates is a secular view that does not dismiss out of hand the prospect that near-term cyclical pressures and the aggressive buying by the Fed does not lead to a test of the yield lows in coming months. It’s just a rally I would be glad to face as it probably is the last gasp in this three-decade old bond bull phase. Unless you do believe in deflation, it is going to be difficult to hold every maturity to the 10-year T-note negative in real terms (adjusted for the core CPI trend) and negative relative to nominal GDP across the entire curve indefinitely — that last part is only sustainable in a period of negative real growth rates which is hardly the case today and remains an elusive forecast for many a pundit. Have a look at Ben Bernanke’s analytical piece called *Long-Term Interest Rates* back on March 1st and assess the balance of risks — visibly one-sided even if the timing is up for debate.

The prospect that we are sitting at over 3% on the 10-year T-note yield a year from now and north of 4% by 2017 is hardly trivial. I’ve been in the deflation camp for two decades ... but strongly feel it is time to move on. It is a crowded trade. I used to say in the 1990s and 2000s that we had a generation of market pundits and players who only know higher interest rates and inflation. Today, we have a group of twenty, thirty and even forty-somethings who know little about bond selloffs, inflation or even what a normal Fed tightening cycle looks like. The new paradigm has shifted in the opposite direction and today’s ever-more consensus forecast of 1% yields on 10-year T-notes and 2% on the long bond based on deflation reminds me of the bold calls for 30% bond yields back in the early 1980s based on runaway inflation. Rosie’s Rule #4: *“Fall in love with your partner, not your forecast”*.

A recent McKinsey study found that only 43% of employers surveyed in nine countries believed they had a sufficient pool of skilled entry-level workers to choose from. Not only that, but mid-sized firms (between 50 and 500 employees) had an average of 13 entry-level positions sitting vacant. In other words, this is far more a skills mis-match story than one related to aging (though not aged) baby boomers. The reality is that employment has risen some three million since mid-2009 but for some reason, nine million adult Americans dropped out of the labour market altogether over this time frame. The demand is there with job openings rising 81% from the cycle lows and layoffs down 41%. The problem is that new hires are stagnating at best, and this is why the workweek is

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being lengthened and overtime hours being expanded. And the working class is beginning to notice that it is starting to have some bargaining power as the number of voluntary quits has risen 35% so far this cycle and are flirting near 4½-year highs.

While gross hirings are anemic, to be sure, companies are trying to hang onto their staff and as such, layoff rates have come down a long way. There may well be 90 million American adults outside of the labour market and another 12 million in the jobless ranks looking for a job but can't find one because they don't have the right skills, but rest assured that the 144 million who are gainfully employed are becoming ever more confident in their own prospects, and that is, again, underscored by a "voluntary quit" rate that has also risen to a cycle high.

No matter the reason, the reality is that capacity is being taken out of the jobs market (much like it has in the airline sector which is one area that now has pricing power as a result), and as such, less competition for available jobs will likely result in rising wage rates unless the laws of supply and demand have managed to bypass the labour market. Much of this "capacity reduction" may reflect the fact that an ever-rising number of the "99%" are actually getting paid not to work. So I would say this may be more about the incentive system than demographics.

For example, a record 23 million households are now on food stamps — up over 735,000 from a year ago and now this is representing close to 30% of the total number of adults who now reside outside the confines of the labour force. There are also nearly nine million Americans on disability and I do not want to at all disparage those who are truly physically hurt, but my only point is that the SSDI program (Social Security Disability Insurance) is bursting at the seams, having jumped by one million workers in just the past three years and 300,000 of these in just the past three months — an annual expense (to the taxpayer and it is non-wage income to the recipient) of \$165 billion.

It will not be a straight line up, and in fact, I see the prospect of a still-oversold bond market seeing lower yield activity over the near-term, but don't confuse the small and big picture here. The big picture is that the lows in Treasury yields were turned in a year ago when a three-decade secular bull market came to an end, and a secular bear market was in its infancy. You want more evidence? Go to the Bernanke piece he penned on March 1st titled "*Long-Term Interest Rates*" and you will see firsthand that the architect of today's super-low interest rates himself sees 10-year T-note yields moving from today's 2.5%-ish level to something closer to 4% or even higher in coming years.

So if you are an issuer, the time for refinancing is now, not later. And if you are an investor, don't spend too long debating whether you should be starting to hedge your portfolio against the prospect of a rising long-

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term interest rate environment, even as central banks continue to keep short-term policy yields at the floor. From the perspective of an economist at a wealth management firm, this means embarking on strategies that over time will effectively hedge out interest rate risk, for example with exposure to hard assets, credit arbitrage, and screening in the equity market for companies with high fixed costs and low variable costs, high ratios of capital to labour, and firms with a proven history of being able to pass on cost increases to protect profit margins.

CHART 1: ROSIE'S BAKER'S DOZEN OF (ECONOMISTS') RULES

- 1 In order for an economic forecast to be relevant, it must be combined with a market call
- 2 Never be a slave to the data — they are no substitute for astute observation of the big picture
- 3 The consensus rarely gets it right and almost always errs on the side of optimism — except at the bottom
- 4 Fall in love with your partner, not your forecast
- 5 No two cycles are ever the same
- 6 Never hide behind your model
- 7 Always seek out corroborating evidence
- 8 Have respect for what the markets are telling you
- 9 Be constantly aware with your forecast horizon — many clients live in the short run
- 10 Of all the market forecasters, Mr. Bond gets it right most often
- 11 Highlight the risks to your forecasts
- 12 Get the U.S. consumer right and everything else will take care of itself
- 13 Expansions are more fun than recessions (straight from Bob Farrell's quiver!)

Source: Gluskin Sheff

CHART 2: DEFLATION HAS BECOME THE CONSENSUS VIEW



Source: Barron's (April 22, 2013)

CHART 3: DEFLATION HAS BECOME THE CONSENSUS VIEW



CHART 4: THE WIZARD IS A HERO!

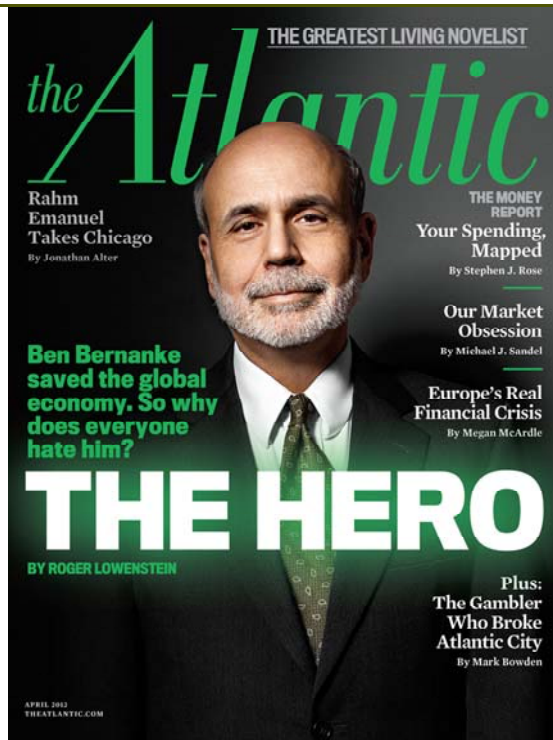
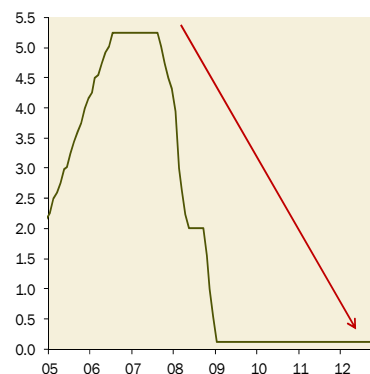


CHART 5: UNPRECEDENTED MONETARY EXPANSION

United States

Fed Funds Rate
(percent)



Source: Haver Analytics, Gluskin Sheff

Fed Balance Sheet - Total Assets
(\$ trillion)

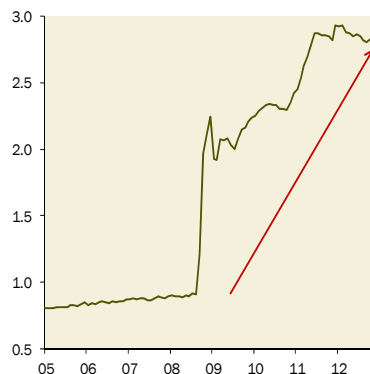
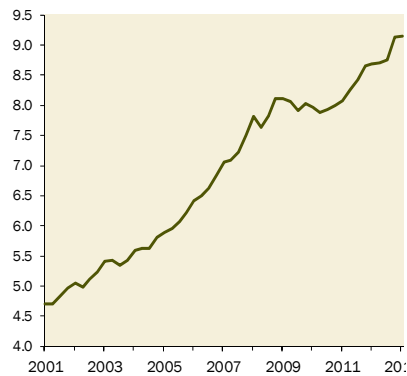


CHART 6: NINE TRILLION IN CASH ... EARNING 0%

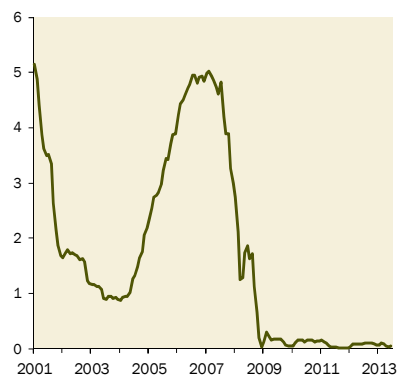
United States

(quarter-over-quarter percent change, annual rate)

Household Cash Assets
(\$ trillions)

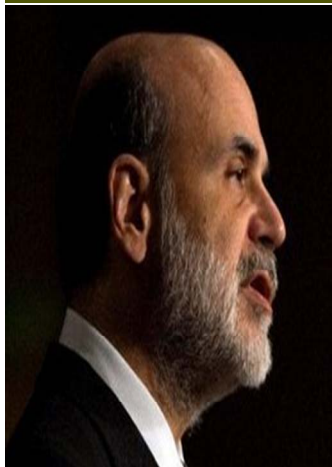


3-Month Treasury Bill Yield
(percent)



Source: Haver Analytics, Gluskin Sheff

CHART 7: HE SAID WHAT??



"We do think that these policies can bring interest rates down, not just treasury rates but a whole range of rates including mortgage rates and rates for corporate bonds and other types of important interest rates. It also affects stock prices. It affects other prices, home prices, for example.

So looking at all the different channels of effect, we think it does have an impact on the economy. It will have impact on the labor market but again, the way I would describe it is a meaningful effect, a significant effect, but not a panacea, not a solution for the whole issue."

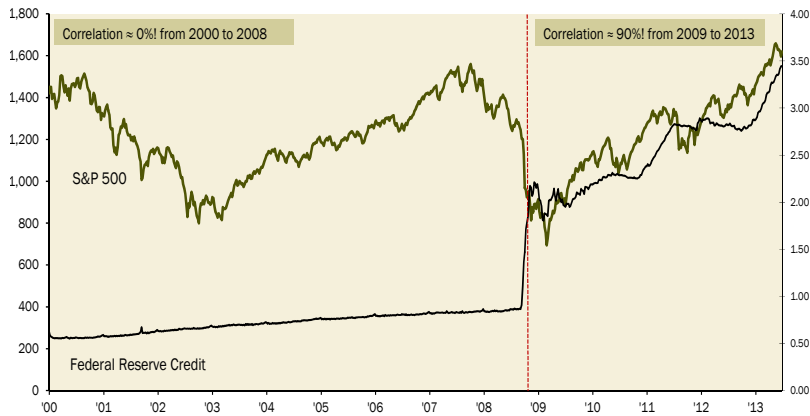
Ben Bernanke
the Post-FOMC Meeting Press Conference
September 13, 2012.

CHART 8: THE STOCK MARKET NOW FOLLOWS THE FED'S BALANCE SHEET

United States

S&P 500 (left axis, index)

Federal Reserve Credit (right axis, \$trillions)



Source: Haver Analytics, Gluskin Sheff

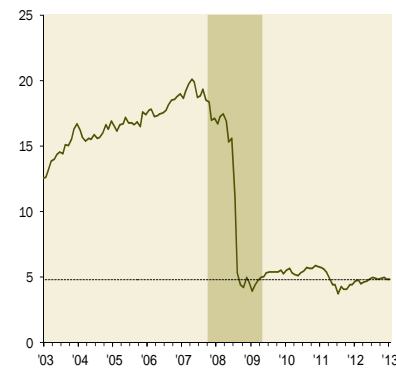
CHART 9: THE POTEMKIN RALLY

United States

NYSE Stock Market Cap
 (\$ billions)



NYSE Mkt Cap/Fed's Total Assets
 (ratio)



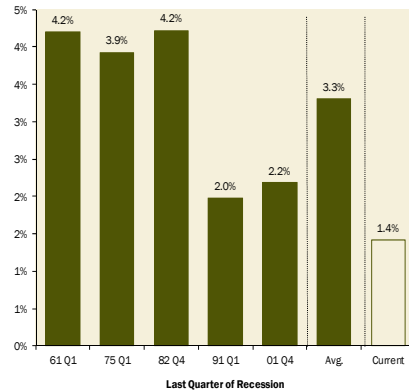
Shaded regions represent periods of U.S. recession

Source: Haver Analytics, Gluskin Sheff

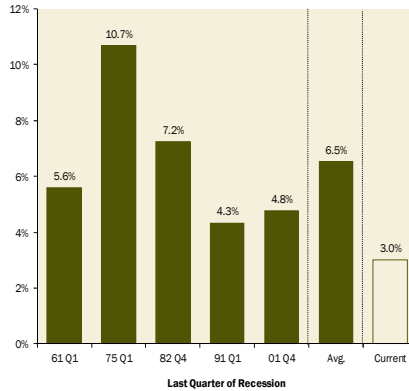
CHART 10: THE POTEMKIN ECONOMIC RECOVERY

United States: 16 Quarters After A Recession Ends

Real GDP per capita
(annualized percent change)



Nominal GDP per capita
(annualized percent change)



Source: Haver Analytics, Gluskin Sheff

CHART 11: SUPPLY CURVE SCLEROSIS

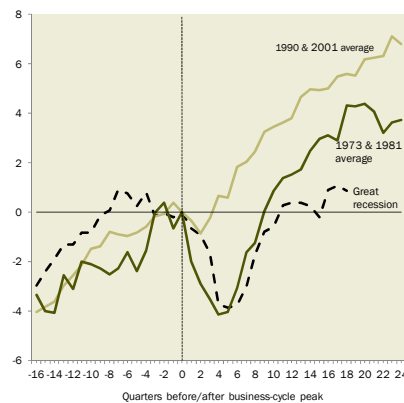
United States

*"The report cites three estimates of the extent to which a lower trend rate explains the weak recovery. One, published in 2012 by James Stock of Harvard University (now a council member) and Mark Watson of Princeton University, derives America's potential growth rate from the long-term average of variables such as employment and productivity. **This approach concludes that 80% of the two-percentage-point shortfall in growth relative to other recoveries is caused by slower potential.**"*

The Economist, March 23, 2013

Total Factor Productivity

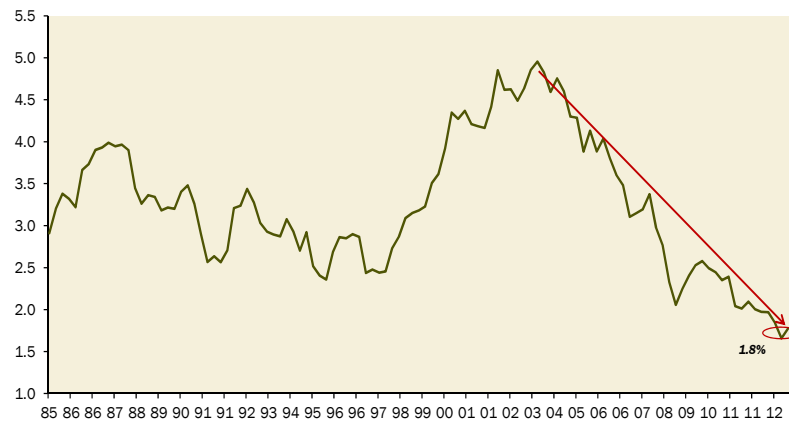
(percent change from business-cycle peak)



Source: Federal Reserve Bank of San Francisco, The Economist, Gluskin Sheff

CHART 12: SECULAR DECLINE IN "POTENTIAL" GDP GROWTH

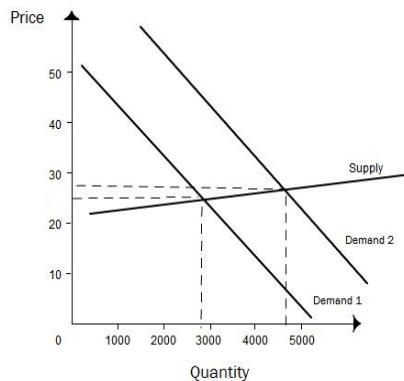
United States: Productivity Growth + Labour Force Growth
(five-year percent change at an annual rate)



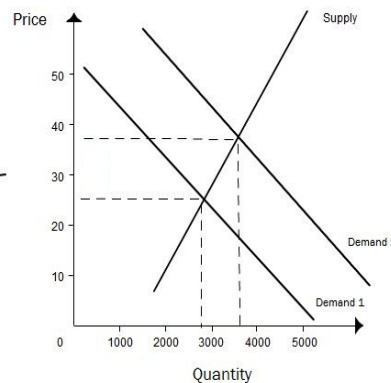
Source: Haver Analytics, Gluskin Sheff

CHART 13: SUPPLY CURVE BECOMING INELASTIC

1980-90's Elastic Supply Curve



Today's Inelastic Supply Curve



Source: Gluskin Sheff

CHART 14: YELLEN AND SCREAMIN' OVER THE CAPEX SHORTFALL

"... the slow recovery has depressed the pace of capital accumulation, and it may also have hindered new business formation and innovation, developments that would have an adverse effect on structural productivity."

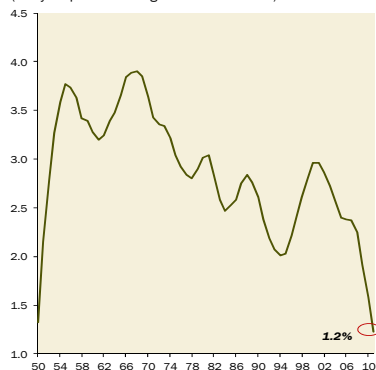


Janet L. Yellen
2013 National Association for Business
Economics Policy Conference
Washington, D.C.
March 4, 2013

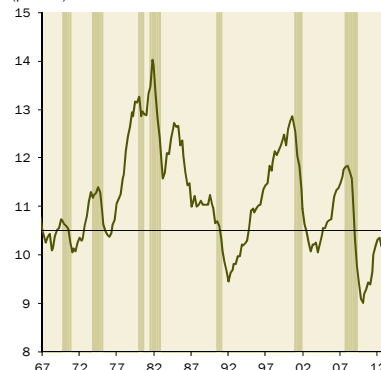
CHART 15: WEAKEST GROWTH IN THE PRIVATE CAPITAL STOCK IN SIX DECADES

United States

Real Net Private Capital Stock
(five-year percent change at an annual rate)



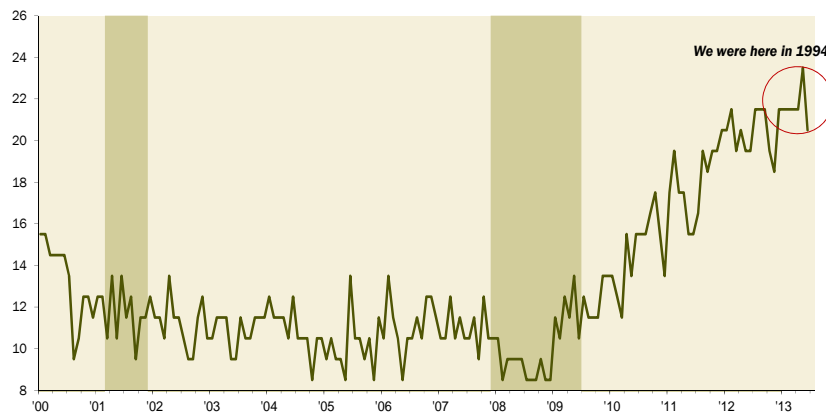
Business Spending as a Share of GDP
(percent)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

CHART 16: GOVERNMENT REGULATION GETS IN THE WAY

United States: NFIB: Government Requirements as the Top Problem
(percent of respondents)



Shaded regions represent periods of U.S. recession

Source: Haver Analytics, Gluskin Sheff

CHART 17: YELLEN AND SCREAMIN' OVER THE LABOUR MARKET

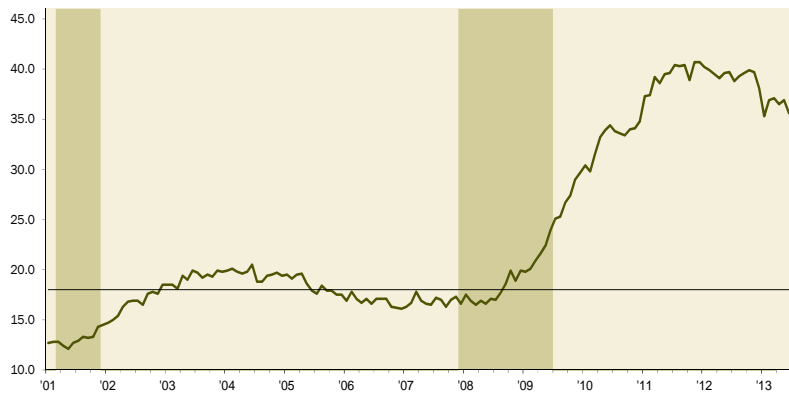
The large shortfall of employment relative to its maximum level has imposed huge burdens on all too many American households and represents a substantial social cost. **In addition, prolonged economic weakness could harm the economy's productive potential for years to come. The long-term unemployed can see their skills erode, making these workers less attractive to employers. If these jobless workers were to become less employable, the natural rate of unemployment might rise or, to the extent that they leave the labor force, we could see a persistently lower rate of labor force participation.**



Janet L. Yellen
2013 National Association for Business Economics
Policy Conference
Washington, D.C.
March 4, 2013

CHART 18: AVERAGE LENGTH OF UNEMPLOYMENT

United States
(weeks)

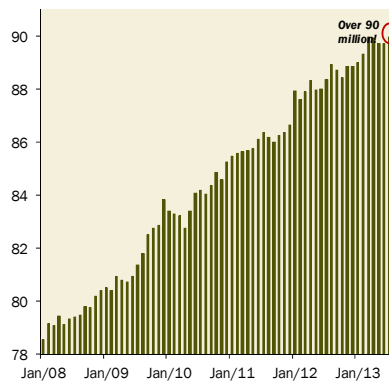


Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

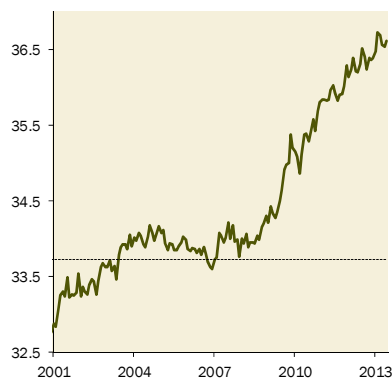
CHART 19: A RECORD NUMBER OF AMERICANS HAVE LEFT THE LABOUR FORCE

United States

People Not in Labor Force



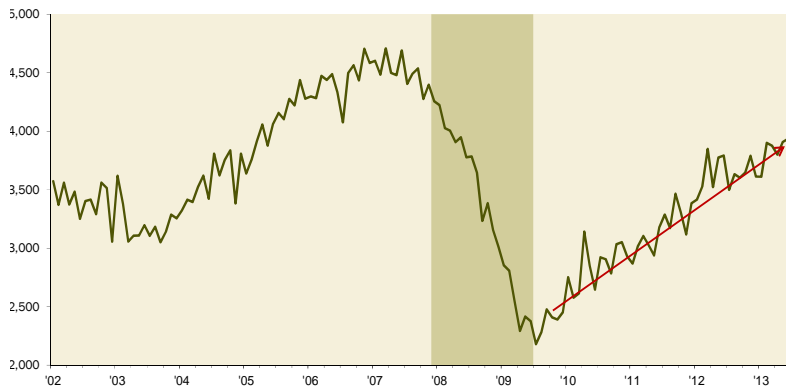
Share of population not in Labour Force



Source: Haver Analytics, Gluskin Sheff

CHART 20: JOB OPENINGS ON THE RISE

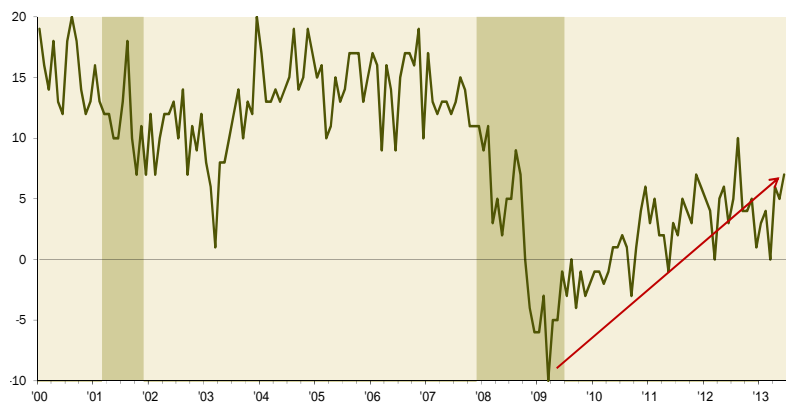
United States: JOLTS: Job Openings
(thousands)



Shaded region represents period of U.S. recession
Source: Haver Analytics, Gluskin Sheff

CHART 21: HIRING INTENTIONS: CHOPPY BUT ON AN UPWARD TRAJECTORY

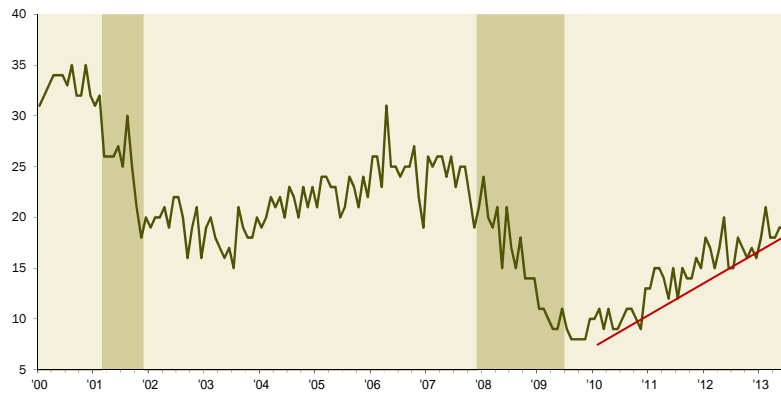
United States: NFIB: Firms Planning to Increase Employment
(percent of respondents)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

CHART 22: FIRMS WITH POSITIONS NOT ABLE TO FILL

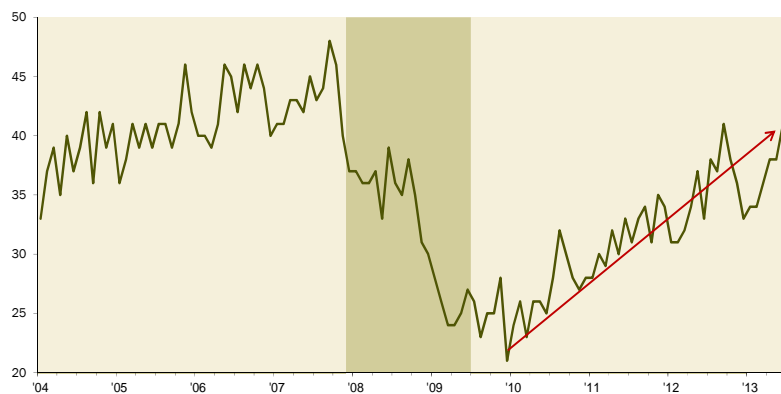
United States: NFIB Survey
(percent of respondents)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

CHART 23: SKILL SHORTAGE IS MORE ACUTE

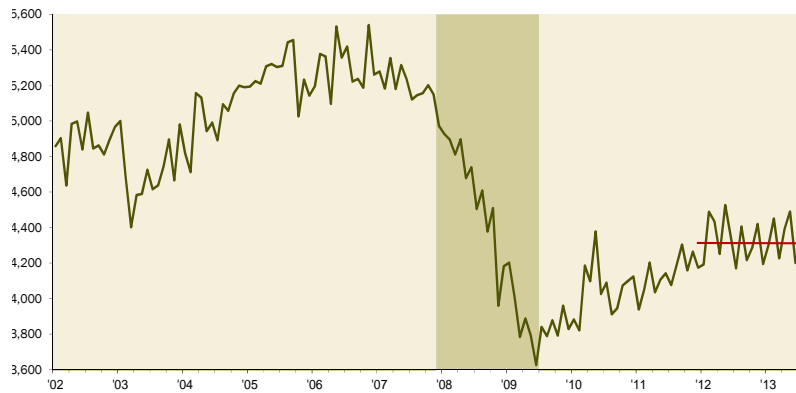
United States: NFIB: Businesses with Few or No Qualified Applicants for Job Openings
(percent of respondents)



Shaded region represents period of U.S. recession
Source: Haver Analytics, Gluskin Sheff

CHART 24: HIRING IS LAGGING BEHIND

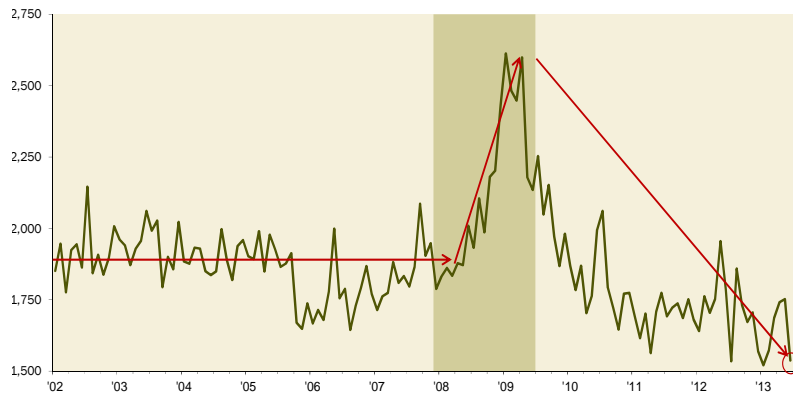
United States: JOLTS: Hires
(thousands)



Shaded region represents period of U.S. recession
Source: Haver Analytics, Gluskin Sheff

CHART 25: FIRINGS PLUNGE (LABOUR HOARDING?)

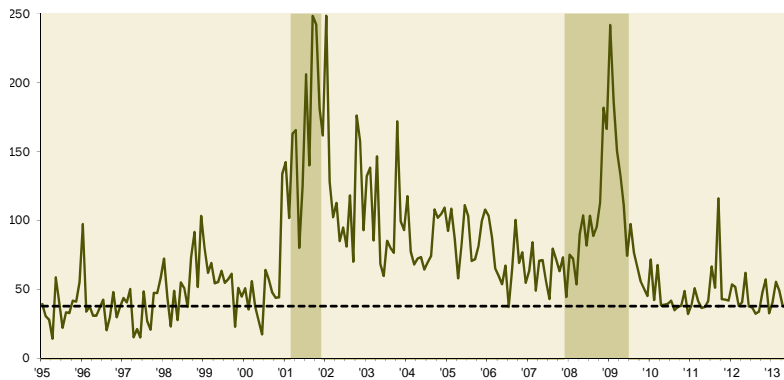
United States: JOLTS: Layoffs and Discharges
(thousands)



Shaded region represents period of U.S. recession
Source: Haver Analytics, Gluskin Sheff

CHART 26: PINK SLIP ANNOUNCEMENTS AT CYCLE LOWS

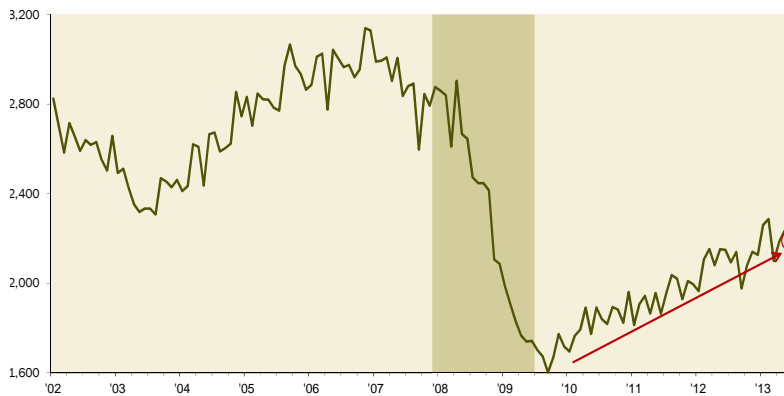
United States: Job Cut Announcements
(thousands)



Shaded region represents period of U.S. recession
Source: Challenger, Gray & Christmas, Gluskin Sheff

CHART 27: NUMBER OF JOB QUITTERS ON THE RISE TOO

United States: JOLTS: Quits
(thousands)



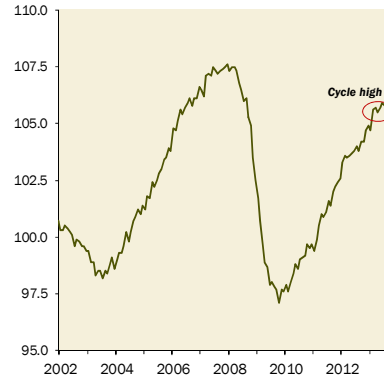
Shaded region represents period of U.S. recession
Source: Haver Analytics, Gluskin Sheff

CHART 28: EMPLOYERS RESORTING TO WORKWEEK EXTENSION

United States

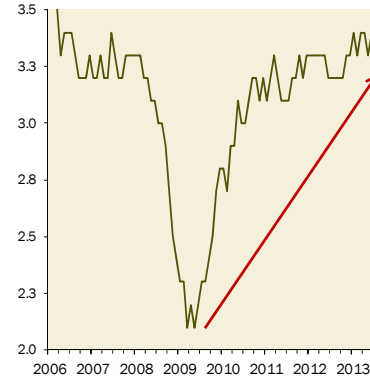
Private Industry Workweek

(index, 2002=100)



Manufacturing Weekly Overtime

(hours)



Source: Haver Analytics, Gluskin Sheff

CHART 29: EARLY SIGNS OF A WAGE RESPONSE?

United States: Average Weekly Earnings

(year-over-year percent change)



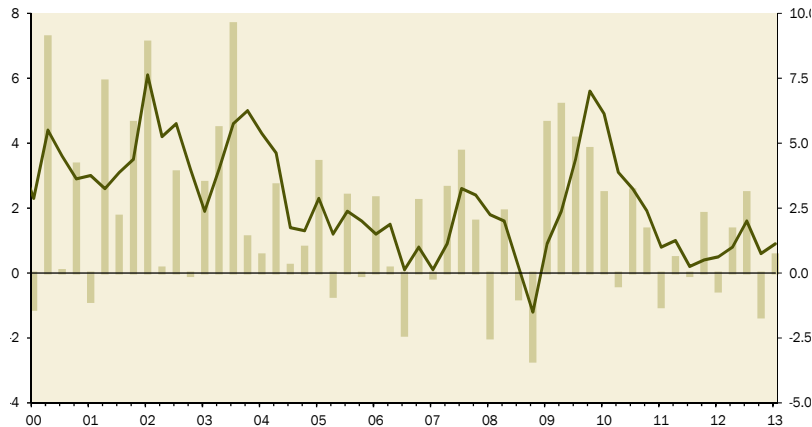
Source: Haver Analytics, Gluskin Sheff

CHART 30: PRODUCTIVITY GROWTH HEADING LOWER

United States: Productivity Growth*

(line: year-over-year percent change, left axis)

(bars: quarter-over-quarter percent change at an annual rate, right axis)



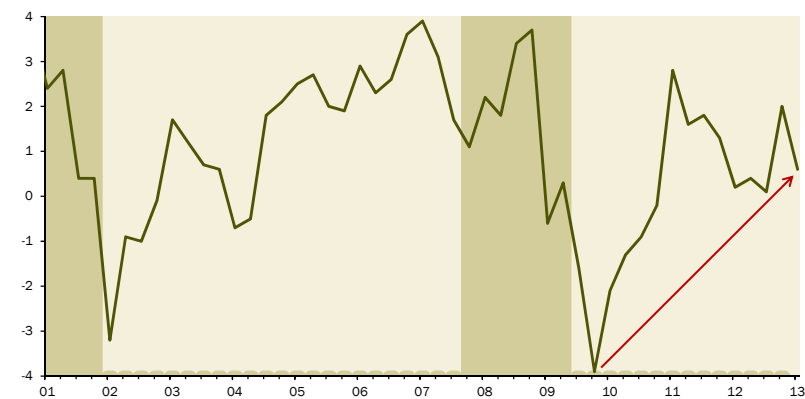
*Real output per hour of all persons in the nonfarm business sector

Source: Haver Analytics, Gluskin Sheff

CHART 31: UNIT LABOUR COSTS REACCELERATE

United States: Unit Labour Costs

(year-over-year percent change)



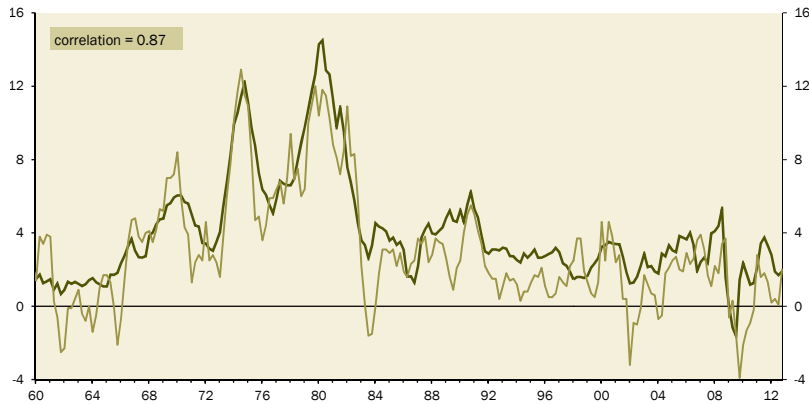
Shaded regions represent periods of U.S. recession

Source: Haver Analytics, Gluskin Sheff

CHART 32: TIGHT HISTORICAL LINK BETWEEN UNIT LABOUR COSTS AND INFLATION

United States

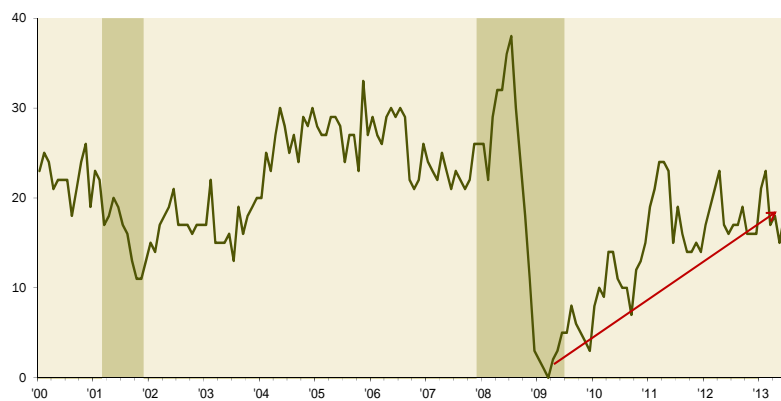
Overall CPI (dark green line, left axis, year-over-year percent change)
Unit Labour Costs (light green line, right axis, year-over-year percent change)



Source: Haver Analytics, Gluskin Sheff

CHART 33: DEFLATION — YESTERDAY’S STORY

United States: NFIB: Firms Planning to Raise Average Selling Prices
(percent of respondents)



Shaded regions represent periods of U.S. recession

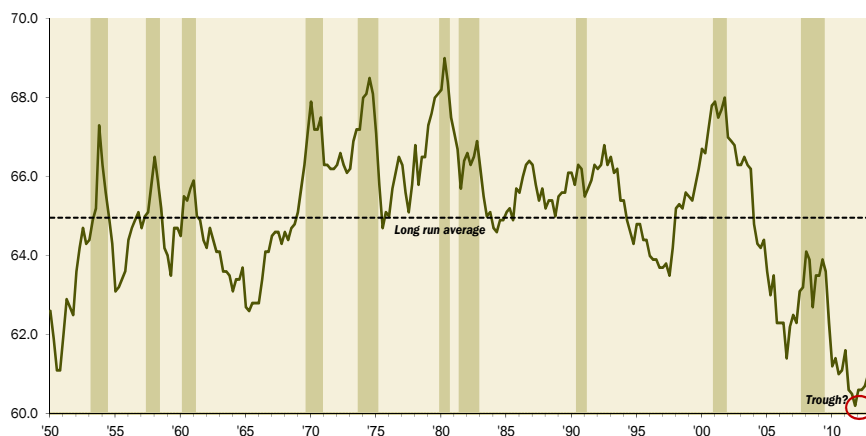
Source: Haver Analytics, Gluskin Sheff

CHART 34: BOB FARRELL'S 10 MARKET RULES TO REMEMBER

- 1 Markets tend to return to the mean over time
- 2 Excesses in one direction will lead to an opposite excess in the other direction
- 3 There are no new eras – excesses are never permanent
- 4 Exponential rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways
- 5 The public buys the most at the top and the least at the bottom
- 6 Fear and greed are stronger than long-term resolve
- 7 Markets are strongest when they are broad and weakest when they narrow to a handful of blue chip names
- 8 Bear markets have three stages – i) sharp down, ii) reflexive rebound, and iii) a drawn-out fundamental downtrend
- 9 When all the experts and forecasts agree, something else is going to happen
- 10 Bull markets are more fun than bear markets

CHART 35: LABOUR PAINS COME TO AN END?

United States: Labour Share of National Income
(percent)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

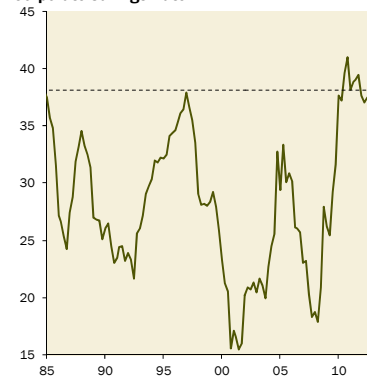
CHART 36: A TRANSFER OF INCOME TO THE PERSONAL SECTOR MAY BE A GOOD THING

United States
(percent)

Personal Savings Rate



Corporate Savings Rate*



* Non-financial net savings divided by total internal funds plus inventory valuation adjustment

Source: Haver Analytics, Gluskin Sheff

CHART 37: FROM DELEVERAGING TO RELEVERAGING?

United States: Household Debt

HH Borrowing from Credit Market

(\$ billions, annual rate)



Total HH Debt

(year-over-year percent change)



Shaded regions represent periods of U.S. recession

Source: Haver Analytics, Gluskin Sheff

CHART 38

“One purpose of this support is to prompt a return to the productive risk-taking that is essential to robust growth and to getting the unemployed back to work.” – Long-Term Interest Rates, 2013, Ben Bernanke



CHART 39: BERNANKE DUSTS OFF THE “PHILLIPS CURVE”

FOMC meeting – June 22, 2011

The Committee continues to anticipate that economic conditions—including low rates of resource utilization and a subdued outlook for inflation over the medium run – are likely to warrant exceptionally low levels for the federal funds rate for an extended period.

FOMC meeting – August 9, 2011

The Committee currently anticipates that economic conditions—including low rates of resource utilization and a subdued outlook for inflation over the medium run – are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013.

FOMC meeting – January 25, 2012

In particular, the Committee decided today to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that economic conditions – including low rates of resource utilization and a subdued outlook for inflation over the medium run—are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014.

FOMC meeting – September 13, 2012

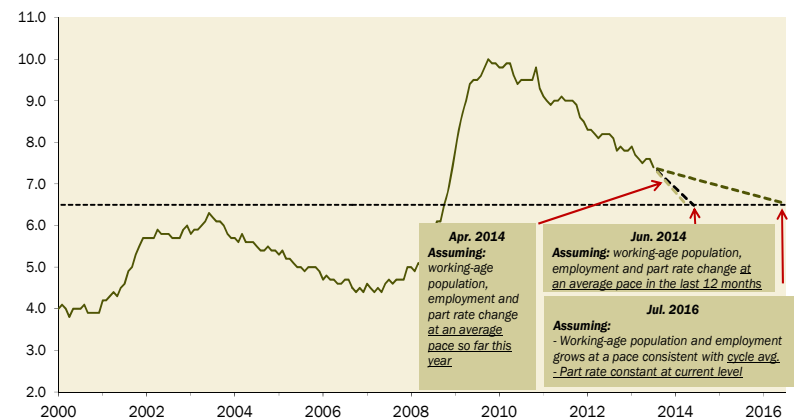
In particular, the Committee also decided today to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that exceptionally low levels for the federal funds rate are likely to be warranted at least through mid-2015.

FOMC meeting – December 12, 2012

In particular, the Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored.

CHART 40: IF ASSUMPTIONS CHANGE, SO DO THE CONCLUSIONS

United States: United States: Unemployment Rate
(percent)

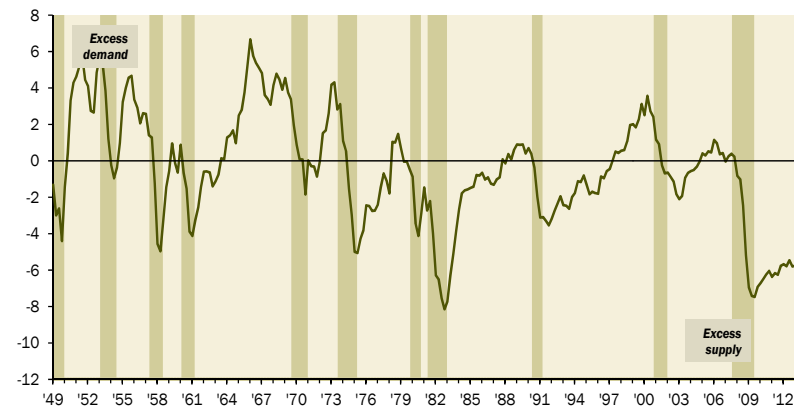


Dashed lines represent estimates

Source: Haver Analytics, Gluskin Sheff

CHART 41: THE FED RESPONDS TO THE "OUTPUT GAP"

United States: Output Gap as Percent of Potential GDP
(percent)



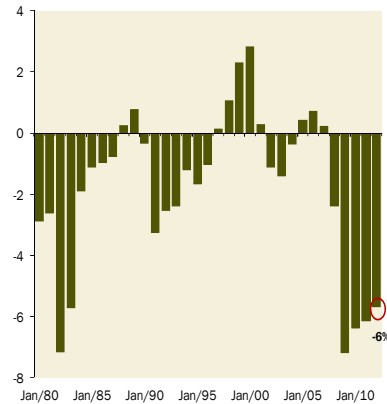
Shaded regions represent periods of U.S. recession

Source: Haver Analytics, Gluskin Sheff

CHART 42: IS THE OUTPUT GAP REALLY 6%?

United States
(percent)

Output Gap



Core CPI*



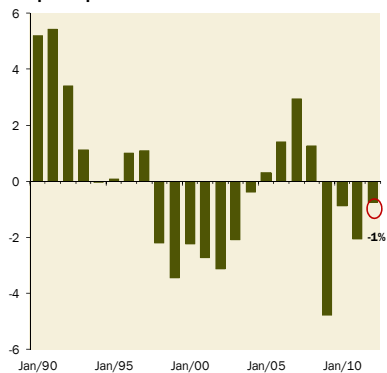
*CPI ex food and energy, YoY

Source: Haver Analytics, Gluskin Sheff

CHART 43: JAPAN HAS A 1% OUTPUT AND -0.3% CORE INFLATION

Japan
(percent)

Output Gap



Core CPI*

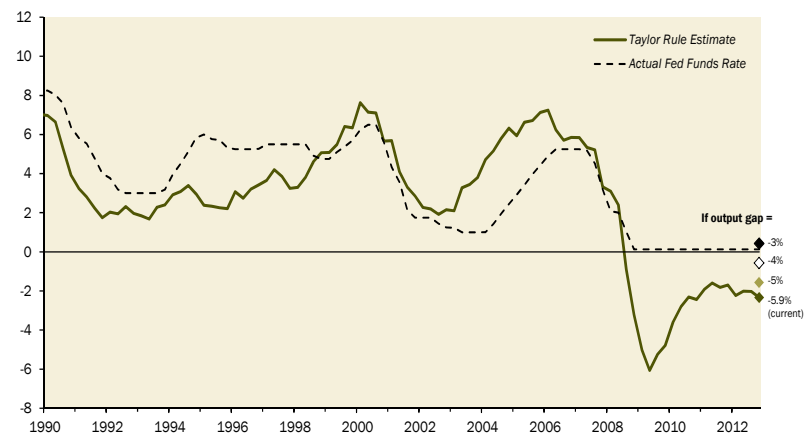


*CPI ex food and energy, YoY

Source: Haver Analytics, Gluskin Sheff

CHART 44: EQUILIBRIUM FED FUNDS RATE IS ALSO SENSITIVE TO OUTPUT ESTIMATES

United States: Fed Funds Rate and Taylor-rule Estimate
(percent)



Source: Haver Analytics, Gluskin Sheff

CHART 45: FED PURSUING FINANCIAL INSTABILITY?

*It follows that the FOMC will only be able to meet its objectives over that time frame by taking policy actions that ensure that **the real interest rate remains unusually low.***

*I then point out that low real interest rates can be expected to be associated with financial market phenomena that are seen as signifying instability. **It follows that, for many years to come, the FOMC will only be able to achieve its congressionally mandated objectives by following policies that result in signs of financial market instability.***



Narayana Kocherlakota
President of FRB of Minneapolis
"Low Real Interest Rates"
April 18, 2013

CHART 46: BURNS RETURNS!

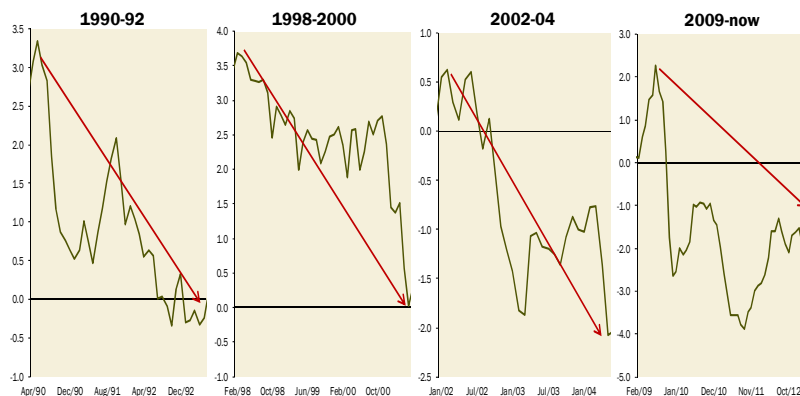
United States: Real Fed Funds Rate*
 (percent)



Source: Haver Analytics, Gluskin Sheff

CHART 47: THE FED'S EXPERIMENTS IN PROVIDING NEGATIVE REAL RATES ...

United States: Three-month Treasury Yield minus CPI YoY
 (percent)

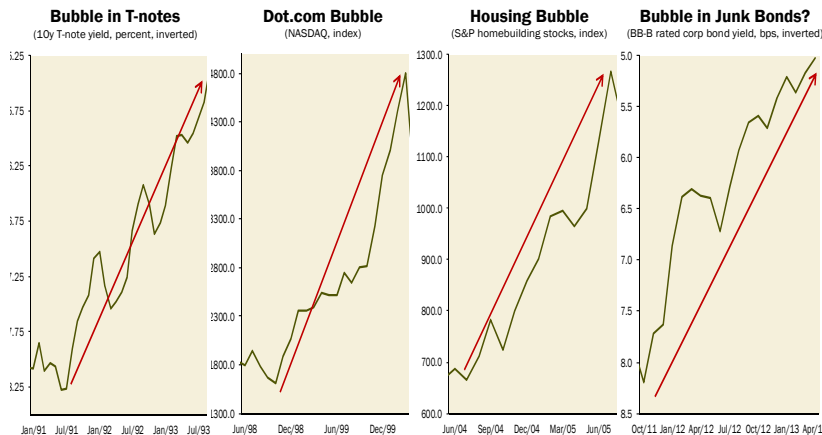


Source: Haver Analytics, Gluskin Sheff

CHART 48: ... HAVE ALWAYS LED TO EXCESS

United States

(quarter-over-quarter percent change, annual rate)



Source: Haver Analytics, Gluskin Sheff

CHART 49: RECALL WHAT LARRY MEYER SAID BACK IN 2000

So, is there a new economy? As I said, it depends. For my part, I accept the proposition that there has been a significant improvement in underlying productivity growth in the United States, that it is very closely tied to improvements in information and communications technology, and that it is likely to spread around the world. **But I resist the new economy label because it seems to encourage a disrespect for the old rules that could seriously undermine our success in taking advantage of the new opportunities.**

The second insight—and enduring old economy wisdom—is that a proximate source of changes in inflation is an imbalance between the levels of aggregate supply and aggregate demand. This can be expressed as an imbalance between actual and potential output or as a divergence of the unemployment rate from the NAIRU. The imbalance between the growth rates of aggregate supply and demand is, of course, the source of changes in the balance between the levels of aggregate demand and supply. But inflation is related directly to the levels not to the growth imbalance.

And, even in the new economy, excess aggregate demand ultimately drives up inflation. Thus the limits may have changed, but the consequences of overtaxing the limits remain the same.



Governor Laurence Meyer
“The New Economy Meets Supply and Demand”
June 6, 2000

CHART 50: REMEMBER MISHKIN IN AUGUST 2007!

So far, I have discussed monetary transmission mechanisms working through the housing sector when the financial system is operating normally. **However, exceptionally unfavorable conditions in the housing sector have the potential to create instability in the financial system—instability that could magnify problems for the overall economy.** Two questions thus arise: Through what channels might the housing sector at times be a source of financial instability? And could such instability affect the operation of the transmission mechanism, affecting the ability of a central bank to stabilize the overall macroeconomy?

A breakdown in financial stability occurs when shocks to the financial system cause disruptions to the credit intermediaries that are so severe that the system can no longer channel funds fluidly to creditworthy households and businesses with productive investment opportunities. Without access to financing, individuals and firms must cut their spending, which will have consequences for overall economic activity.

The typical channel has been that sharp asset-price declines have seriously deteriorated the balance sheets of key financial institutions, inhibiting them from using their advantage of information capital to make loans to firms and individuals. **...It bears asking whether the sharp slowing in U.S. home price appreciation, and in some areas of the country a turn to outright declines, has created a substantial risk of financial instability with adverse implications for macroeconomic performance.**

Because prices of homes, like other asset prices, are inherently forward looking, it is quite difficult to conclude firmly whether they are above their fundamental values, and researchers have come to conflicting conclusions. **Nevertheless, an explosive rise in asset prices always generates concern that a bubble may be developing and that its bursting might lead to broad and deep economic distress.**



Fed Governor Frederic S. Mishkin
August 3, 2007

CHART 51: CREDIT BUBBLE? IF IT QUACKS LIKE A DUCK ...

"The third factor that can lead to overheating is a change in the economic environment that alters the risk-taking incentives of agents making credit decisions. **For example, a prolonged period of low interest rates, of the sort we are experiencing today, can create incentives for agents to take on greater duration or credit risks, or to employ additional financial leverage, in an effort to "reach for yield" ...**

Putting it all together, my reading of the evidence is that we are seeing a fairly significant pattern of reaching-for-yield behavior emerging in corporate credit.

The question of how policymakers should respond to different manifestations of credit market overheating is a big and difficult one, and I won't attempt to deliver a set of specific prescriptions here.

To lend a little concreteness and urgency to this issue, imagine that it is 18 months from now, and that with interest rates still very low, each of the trends that I identified earlier has continued to build — to the point where we believe that there could be meaningful systemic implications. What, if any, policy measures should be contemplated?"



Fed Governor Jeremy Stein
"Overheating in Credit Markets: Origins,
Measurement, and Policy Responses"
February 7, 2013

CHART 52



“If something cannot go on forever, it will stop.”

— Herbert Stein’s Law

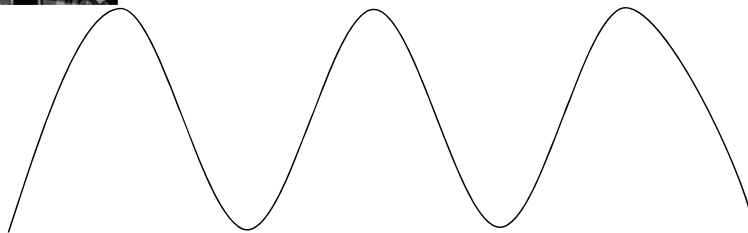


CHART 53: ROUND TRIP FOR BOND YIELDS

United States: 10-year T-note Yield
(percent)



Source: Haver Analytics, Gluskin Sheff

CHART 54: HAVE BOND BULLS READ BERNANKE'S PIECE?

For release on delivery
10:00 p.m. EST (7 p.m. PST)
March 1, 2013

Long-Term Interest Rates

Remarks by

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

at the

Annual Monetary/Macroeconomics Conference: The Past and Future of Monetary Policy

Sponsored by Federal Reserve Bank of San Francisco

San Francisco, California

March 1, 2013

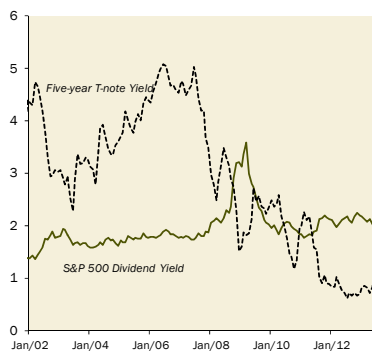
Source: Federal Reserve Board

CHART 55: ARGUABLY THE MOST COMPELLING ARGUMENT FOR EQUITIES

United States: S&P 500 Dividend Yield and Five-year T-note Yield

Yield Levels

(percent)



Source: Haver Analytics, Gluskin Sheff

Spread

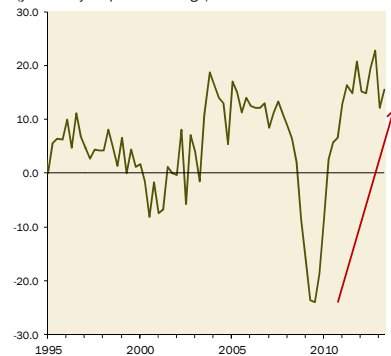
(basis points)



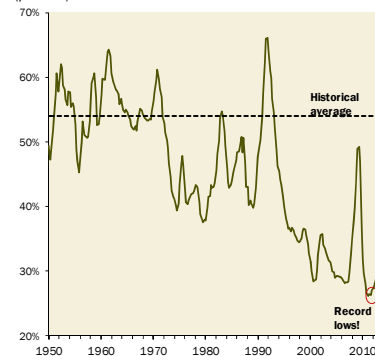
CHART 56: DIVIDENDS — GROWTH TRUMPS YIELD

United States

S&P 500 Dividend per Share
(year-over-year percent change)



Dividend Payout Ratio
(percent)



Source: Bank of America Merrill Lynch, Haver Analytics, Gluskin Sheff

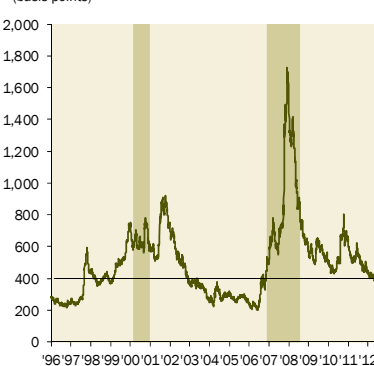
CHART 57: JUNK BONDS AT 5% YIELD?

United States: Corporate Bond Spread

BB-B Rated Corporate Bond Yield
(percent)



BB-B Rated Spread off Treasury Master
(basis points)

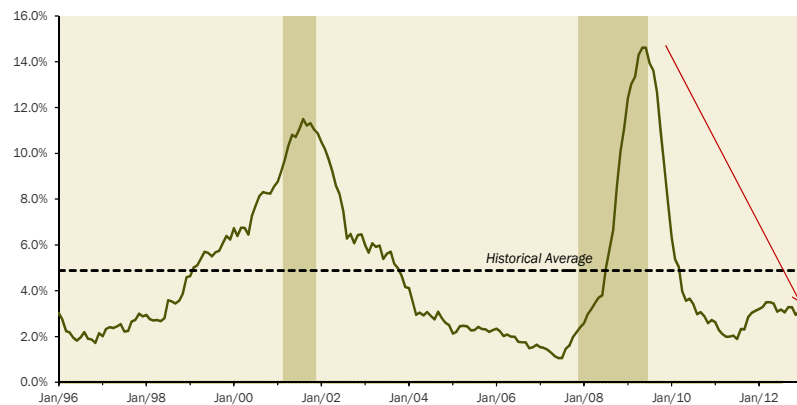


Shaded regions represent periods of U.S. recession

Source: Haver Analytics, Gluskin Sheff

CHART 58: CORPORATE DEFAULT RATES MATCH STRONG BALANCE SHEET FUNDAMENTALS

United States: High Yield Corporate Bond Default Rates
 (percent)

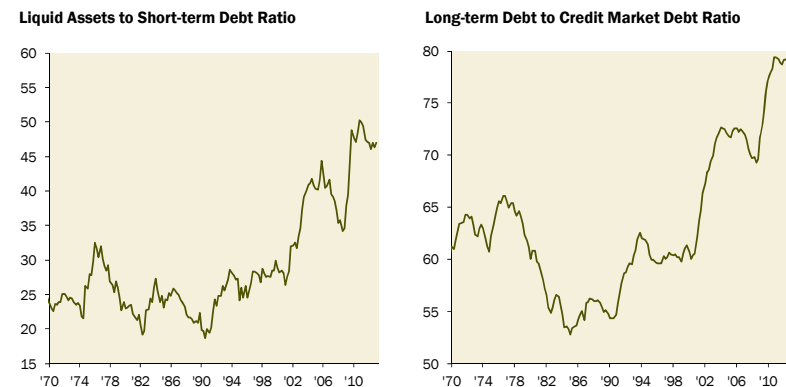


Shaded regions represent periods of U.S. recession

Source: Barclays Capital, Gluskin Sheff

CHART 59: CORPORATE SECTOR FINANCES IN GOOD SHAPE

United States: Nonfarm Nonfinancial Corporate Business
 (percent)



Source: Haver Analytics, Gluskin Sheff

CHART 60: NEXT STRATEGY SHIFT: FROM S.I.R.P. TO H.I.R.P. — HEDGED INFLATION RISK PROTECTION

- Real estate
- TIPS
- Art/collectibles
- Gold/silver
- Banks
- Consumer staples
- Energy
- Metals
- Agriculture
- Credit arbitrage
- Long-short strategies
- Volatility
- Loonie, Aussie, Kiwi

Source: Gluskin Sheff

CHART 61: EQUITY SECTOR SELECTION IN A COST-PUSH STAGFLATION ENVIRONMENT

- Consumer staples
- Consumer Discretionary
- Utilities
- Telecom
- Commercial banks
- Cable/Media
- Oil & Gas — Exploration & Production /Refining/Energy Equipment & Services
- Industrial Conglomerates / Electrical Power
- Road & Railroads
- Machinery
- Airlines
- Basic materials
- Precious metals
- Specialty chemicals
- Paper packaging

Source: Gluskin Sheff

OVERVIEW OF THEMES AND STRATEGIES

THEME	STRATEGY/IDEA	SECTOR/ASSET CLASS
Redeployment of Capital	Companies which have deployed or have capacity (and a track record) to deploy excess capital to generate risk-adjusted returns which exceeds their cost of capital.	Special situations
Income Orientation	Focus on reliable dividend <u>growth</u> and dividend yield; Being and staying ahead of the robust demographic (baby-boomers aging) shift towards income oriented investments. Safety and Income at a Reasonable Price (S.I.R.P.).	Income-oriented stocks with the ability to sustain and <u>grow</u> dividends
Financials	A focus on companies whose business model would benefit from a rising interest rate environment over the longer term; A steeper yield curve would also benefit banks as well; Focus on those that are at or near Basel III compliance, trade below book and will see NIM expansion from rising rates.	Insurance companies Banks
Canadian credit	Although Verizon is certainly a threat to the incumbent firms in Canada, we think this is a bigger equity/earnings risk and still feel comfortable with these companies from a credit perspective; Even when the credit markets were strong and spreads were moving materially tighter, deposit notes have been the major laggard in Canadian credit so far in 2013.	Credit of Canadian telecom companies Canadian bank deposit notes
Energy Infrastructure	There are mega-billions of dollars worth of projects awaiting approval in North America for the distribution of natural gas both for domestic consumption and export. The multi-year trend toward increasing gas consumption will benefit companies that have expertise in building natural gas infrastructure and liquefaction/gas-to-liquid technology.	Engineering & Construction companies specialized in natural gas infrastructure
Auto Recovery	The profitability leverage for the likes of Ford and GM is considerable when the global automotive industry begins to improve.	U.S. auto manufacturers Auto parts suppliers
European Domestic Demand Plays	The region is swinging back to positive growth for the first time in two years; We favour western European Telecom names on the back of "less bad" results. Expectations remain extremely low for this group.	European Financials, Industrials, Healthcare, Consumer Discretionary Western European Telecom Companies
Mobility/Connectivity and IT Infrastructure	Focus on those firms that benefit from the secular trend surrounding the portability of data and increased consumer usage of smartphones/tablets; Identify and invest in firms that benefit from cloud-based strategies that allow customers to be more efficient and realize cost savings.	Technology firms Cellular carriers/Tower companies
Non-Cyclical	Focus on special situations that are not correlated with the economic cycle.	Defense-aerospace Healthcare Dollar/Discount stores

Capital Preservation	Lock in high-quality corporate bond spreads in non-cyclical sectors;	Income-producing equities, preferreds and bonds
	Minimize volatility via alternative strategies such as long/short equity strategies.	Credit of Canadian Banks, Retailers, Insurance companies
Other	Invest in hard "strategic" assets;	Commercial aerospace companies
	Focus on burgeoning middle class in emerging markets.	Emerging market consumer stocks

Updated: August 14, 2013
Source: Gluskin Sheff

Gluskin Sheff at a Glance

Gluskin Sheff + Associates Inc. is one of Canada's pre-eminent wealth management firms. Founded in 1984 and focused on high net worth private clients and institutional investors, we are dedicated to meeting the needs of our clients by delivering strong, risk-adjusted returns together with the highest level of personalized client service.

OVERVIEW

As of June 30, 2013, the Firm managed assets of \$6.2 billion. The minimum investment required to establish a client relationship with the Firm is \$3 million.

Gluskin Sheff is a publicly traded corporation on the Toronto Stock Exchange (symbol: GS) and remains 46% owned by its senior management and employees. We have public company accountability and governance with a private company commitment to innovation and service.

LEADING

Our team is an exemplary group of investment professionals deep in talent, ideas and experience with the industry's top leaders in risk management and client service – all with the objective of providing strong risk-adjusted returns and the highest level of personalized client service.

INNOVATIVE

Throughout our history we have been Stubbornly unconventional™, consistently pursuing innovative approaches to wealth management for our clients. Today, we offer a diverse platform of investment strategies, including Canadian, U.S. and international equity strategies, alternative strategies and fixed income strategies.

PERSONAL

For Gluskin Sheff, delivering outstanding client service is as fundamental as delivering strong investment results. Our clients are unique, and so are their needs. This is why we offer customized investment plans to suit each client's specific objectives and risk profile.

Our success in developing lasting client relationships is founded on shared values, a thorough understanding of our clients' goals and a keen desire to earn their trust and confidence.

ALIGNED

Our investment interests are directly aligned with those of our clients, as Gluskin Sheff's management and employees are collectively the largest client of the Firm's investment portfolios. Our clients are our partners, through performance-based fees that are earned only when pre-specified performance benchmarks for clients' investments are exceeded.

PROVEN¹

\$1 million invested in our flagship GS+A Premium Income Portfolio in 2001 (its inception date) would have grown to approximately \$4.5 million² on June 30, 2013 versus \$2.1 million for the S&P/TSX Total Return Index³ over the same period.

Similarly, many of our other long-standing investment strategies have outperformed their relevant benchmarks.

Our investment interests are directly aligned with those of our clients, as Gluskin Sheff's management and employees are collectively the largest client of the Firm's investment portfolios.

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*For further information, please contact
research@gluskinsheff.com*

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1. Past returns are not necessarily indicative of future performance. Rates of return are those of the composite of segregated Premium Income portfolios and are presented net of fees and expenses and assume reinvestment of all income. Portfolios with significant client restrictions which would potentially achieve returns that are not reflective of the manager's portfolio returns are excluded from the composite. Returns of the pooled fund versions of the GS+A Premium Income portfolio are not included in the composite.
2. Investment amounts are presented to reflect the actual return of the composite of segregated Premium Income portfolios and are presented net of fees and expenses.
3. The S&P/TSX Total Return Index calculation is based on the securities included in the S&P/TSX Composite and includes dividends and rights distributions. This index includes only Canadian securities.

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